

TEACHERS' RETIREMENT BOARD  
SUBCOMMITTEE ON CORPORATE GOVERNANCE

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SUBJECT: Corporate Governance Policy

ITEM NUMBER:   4  

ATTACHMENT(S):   1  

ACTION:   X  

DATE OF MEETING: October 13, 1999

INFORMATION:           

PRESENTER(S):            Ms. Okada  
                   Ms. Hester Amey  
                   Mr. Waddell

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Attached for the Subcommittee's review and approval is a proposed program and policy statement for the CalSTRS Corporate Governance Program. At present, the only Board-approved policy documents with respect to this program are the "Financial Responsibility Criteria for Corporate Investments," which pertains primarily to proxy voting matters, and the "Statement of Investment Responsibility," which pertains to Board policy concerning adverse corporate practices. Neither of these documents attempt to set forth a comprehensive statement of the reason for CalSTRS to have a corporate governance program, the legal authority for such a program, or the overall policies and procedures of the program. The attached program statement represents an effort by staff to develop such a comprehensive statement.

For the most part, this document is reflective of current program practice, and contains material that has been presented previously to the Investment Committee when the program was reviewed by the Committee in November, 1997 and March, 1999. The primary new material is with reference to securities litigation, and sets forth a commitment to the development of a policy for CalSTRS participation in securities class action and shareholder derivative litigation and activities related thereto.

In addition to the development of the litigation policy, staff believes that the Subcommittee should, in the coming months, review and revise the Financial Responsibility Criteria for Corporate Investments and the Statement of Investment responsibility in an effort to both update their contents as well as to bring their organization into line with the "policies, procedures, and guidelines" format of the other Investment Office programs.

Staff Recommendation: Staff recommends that the Subcommittee adopt the attached statement of the CalSTRS Corporate Governance Program.

## **CalSTRS CORPORATE GOVERNANCE PROGRAM**

### **A.     Introduction**

***Philosophy:*** The California State Teachers' Retirement System (CalSTRS) is committed to holding and managing equity investments and to exercising the shareholder rights appurtenant to those investments, all for the benefit of its participants and beneficiaries. It is the fiduciary responsibility of the Teachers' Retirement Board (TRB) to discharge its duty in the exclusive interest of the participants and beneficiaries and for the primary purpose of providing benefits to participants and their beneficiaries. The TRB should defray the reasonable expenses of administering the Fund; the investment policy of the Fund should reflect and reinforce this purpose. The TRB views its corporate governance role as that of a catalyst for enhanced management accountability, disclosure and performance. The objective of the TRB's corporate governance effort is to enhance long-term shareholder returns.

CalSTRS is a long-term investor; its long-term strategy is demonstrated through its significant commitment to passively managed portfolios in its three largest asset categories: Domestic Equities, Fixed Income, and International Equities. CalSTRS' thrust in corporate governance is to maximize the longer-term value of the shares, consistent with its role as a significant capital allocator.

***Statutory Authority:*** Education Code Section 22354 requires the Board to retain investment managers who are experienced and knowledgeable in corporate management issues to monitor corporations whose shares are owned by the System plan and to advise the board on the voting of the shares owned by the plan and on all other matters pertaining to corporate governance.

While CalSTRS is not subject to the Employee Retirement Income Security Act (ERISA), applicable provisions of both the California Constitution and the Education Code make clear that CalSTRS' commitment to corporate governance is a diligent exercise of its fiduciary responsibility. As observed by the U.S. Department of Labor:

“In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. ... Moreover, because voting such proxies involves plan asset management, section 403(a) requires that plan trustees have the exclusive authority and responsibility for voting these proxies...”

Thus, CalSTRS' legal authority for corporate governance springs from its fiduciary concerns as a prudent investor and the statutory obligation imposed on it by the Legislature.

## **B. Corporate Governance Policies**

The following represent the approved policies to be used in the exercise of CalSTRS' shareholder rights and the implementation of its Corporate Governance Program. The policies are designed to set boundaries for the management of proxies and other corporate actions. As with all other plan assets, these corporate governance policies cannot be altered without explicit direction from the TRB.

1. **LAWS AND STATUTES:** The Corporate Governance Program (Program) for the California State Teachers' Retirement System (CalSTRS) will be managed in a prudent manner for the sole benefit of the CalSTRS participants and beneficiaries, in accordance with the Teacher's Retirement Laws and other applicable State statutes.
2. **REGULATIONS:** For domestic equities, the Program will comply with the rules of the Securities and Exchange Commission (SEC), equity exchanges, and other regulatory agencies. For non-U.S. equities, the Program will comply with the appropriate regulatory body in the respective country.
3. **PROGRAM OBJECTIVE:** The Program shall be managed to provide long-term enhanced shareholder value through clear and certain disclosure and accountability. Enhancing shareholder value shall always take precedence, non-financial or collateral benefits notwithstanding.
4. **PROGRAM COMPONENTS:** The Program shall consist of the following components:
  - a. Voting of Proxies: CalSTRS will make a best effort to vote all domestic and international proxies; exceptions may be made based on the legal requirements or local conventions of certain markets and where practical difficulties make an informed and meaningful decision impossible. Voting of proxies shall be in conformance with the "Financial Responsibility Criteria for Corporate Investments." (Attachment A)
  - b. Annual Workplan Companies: CalSTRS will continue its practice of identifying for enhanced shareholder action, on an annual basis, companies in which the System holds a significant passive investment position that are underperforming applicable performance benchmarks. In the organization and completion of this Workplan, staff shall consider the market value of the investment, CalSTRS' ownership percentage, and the resources required and the direct cost involved in seeking a desired result.

"Enhanced shareholder action" includes, but is not limited to:

- Informal or formal expressions of concern to company management concerning corporate governance practices that are adversely affecting shareholder value;

- Development of shareholder proposals, either individually or in concert with other institutional investors;
  - Participation by CalSTRS in litigation, consistent with its policy with regards thereto, in the event that the subject company's underperformance is related to matters that are or may become the subject of such litigation.
- c. Corporate Governance Organizations: CalSTRS will continue its active participation in the Council of Institutional Investors and in other forums designed to have an impact on corporate governance practices.
- d. Securities Litigation: In addition to its ongoing practice of monitoring and filing claims as appropriate in securities class action litigation, CalSTRS will develop a policy for active participation in securities class action and shareholder derivative litigation, including but not limited to:
- Criteria for seeking lead plaintiff status in securities class action litigation and/or for the filing of shareholder derivative litigation based upon the financial stake of CalSTRS in the litigation recovery, the opportunity to enhance the value of a long-term holding in the subject company through the inclusion of governance reforms in a class action settlement, and/or the potential deterrent effect of the case on future corporate wrongdoing.
  - Criteria for participation in securities class action litigation and/or shareholder derivative litigation other than as lead counsel, such as monitoring of significant cases, the provision of *amicus curiae* or other assistance to institutional investors in such litigation pursuing interests aligned with CalSTRS, and intervention in such cases where appropriate to protect or advance CalSTRS' interests.
  - Criteria for working cooperatively with regulatory authorities such as the SEC, with securities exchanges and with prosecutorial authorities to bring about more aggressive civil and criminal sanctions against corporate officers and employees engaged in fraudulent behavior that undermines the integrity of the financial markets.
- e. Statement of Investment Responsibility: The "Statement of Investment Responsibility" (Attachment B) remains in effect.
5. **BUSINESS PLAN**: The Program will be managed in accordance with a business plan which will be prepared on an annual basis and will describe CalSTRS' objectives for the next twelve-month period.
6. **MONITORING**: Staff shall monitor adherence to the corporate governance policy for all internal and external managed portfolios.
7. **AUTHORIZED ACCESS**: Authorization memoranda, delineating access and authority levels relating to CalSTRS corporate governance related business, will be provided to the master custodian, staff and proxy voting intermediary. Whenever there is a change in

authorized personnel a written notice shall be provided to each affected party, within 48 hours of change.

8. **DELEGATION OF AUTHORITY:** The Chief Investment Officer (CIO) or designee has the authority to manage the Corporate Governance Program and may use other investment personnel to implement these policies.
9. **DECISION-MAKING AUTHORITY:** Subject to the review and approval of the Investment Committee and the TRB, the Subcommittee on Corporate Governance shall:
  - Review and make recommendations with regard to this Policy, the Financial Responsibility Criteria for Corporate Investments (Attachment A), the Statement of Investment Responsibility (Attachment B);
  - Receive reports from staff on the status of current proxy votes, and recommend to the Investment Committee action to be taken on votes which do not fall within the guidelines;
  - Direct development of the Annual Corporate Governance Plan;
  - Receive from staff annual summaries of votes cast on behalf of the Board;
  - Act as liaison between the Board and the Council of Institutional Investors;
  - Monitor developments in the corporate governance area that may affect the value of shares held by the System;
  - Develop and propose various actions related to corporate governance, including, but not limited to, shareholder resolutions, criteria for selection of companies for focus lists, criteria for entering into litigation related to securities fraud and/or to accomplish the purposes of the corporate governance policy.
10. **REPORTING:** Staff shall present quarterly reports to the Sub-Committee on Corporate Governance on all actions taken to implement the corporate governance policy, including corporate actions, litigation, and proxy votes cast.

**CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM  
FINANCIAL RESPONSIBILITY CRITERIA  
FOR CORPORATE INVESTMENTS**

The following criteria deal with matters considered of a financial nature only. In most cases they are general policy guidelines to voting shares held at annual and special corporation shareholder meetings. They are not designed to substitute for analysis and judgement which should be exercised as circumstances dictate. The guidelines should not be regarded as mandatory, if local factors and prudence suggest otherwise. Each issue will be reviewed to ascertain surrounding facts, and exceptions may be made based on the legal requirements of the countries, local conventions or states in which the company is registered. It is recognized that, in foreign markets, there may be practical difficulties in obtaining notices of company meetings and that the timeliness and disclosure requirements, which prevail in the U.S., are often not evident. In those circumstances where adequate and timely disclosure of information necessary to reach an informed and meaningful decision is not possible, the responsible party may abstain. It is also recognized that the decision to abstain by the party responsible for voting the proxy may be due to practical difficulties, to other financial criteria which outweigh the benefits to be gained by voting or to practical difficulties and circumstances beyond its control. (1) Notwithstanding any limitations, it is expected that there will be no abstentions on issues that may affect the economic value of the shareholdings. It is expected that in all cases, the parties will make a good faith effort to get the necessary materials, but it is recognized that, in foreign markets, the means for obtaining planned company meeting notices, dates and agendas, may not be readily available. Nevertheless, a true and accurate record shall be kept of the materials, which have been obtained, and of how proxies have been voted or otherwise managed. This record shall include, to the extent possible, a description of efforts made to obtain materials, which were not successful and the reasons why the efforts were not successful. It is understood that it is the intent of the Teachers' Retirement Board to exercise its voting authority, either directly or through other parties, to whom it has delegated responsibility for voting proxies, according to their judgement of its best financial interests, whenever and wherever possible, and that, while logistics or other factors may sometimes interfere with this intent and principle, it is the ultimate goal of the System to work with the indicated parties to remove the barriers to voting all shares over time.

**A. AUDITORS**

When there is reason to believe the company's auditors have become complacent in the performance of their auditing duties, a vote against that auditors' continuance may be cast.

**B. BOARD OF DIRECTORS**

1. Generally, information and circumstances permitting, votes are to be cast in favor of annual election of all directors and against staggered terms. Exceptions may be made as circumstances dictate or when pertinent information is unavailable. Once all shareholders have decided through the voting process that the board should be staggered, nominees

should be elected based on their qualifications and merits, though STRS' interest may argue for actions proposing the repeal of staggered terms.

2. Generally, votes are to be cast in favor of simple majority approval, of shares outstanding, as appropriate for merger proposals. Proposals seeking higher percentages may be approved only if approval is in the financial interest of STRS. Exceptions may be made when pertinent information is unavailable. For example, a proposal which sought to reduce the super majority requirement from 80% to 66 2/3% would generally receive a favorable vote; whereas, a proposal to increase the vote required from a simple majority to a higher percentage would generally not receive a favorable vote.
3. It is concluded that corporate board members primary responsibilities should be to direct the companies in the interest of all the shareholders. Any proposed director qualifications should relate to a prospective director's capacity to function on behalf of all the shareholders; to the extent that such qualifications are disclosed, votes are to be cast on this basis. However, as a matter of policy, STRS supports the concept of an independent non-executive chairman, who has not had a substantive employment relationship with the company in the past five years. Shareholder proposals which seek a non-executive chairman will generally receive support and may be introduced on behalf of STRS.

Sitting directors who have been on the board for a full year and who have not attended at least 75% of the meetings will receive a negative vote. In such cases, the System will split its votes on the issue of directors and vote against the individual nominee. In casting its vote regarding directors, the financial performance of the subject corporations will be reviewed, and if long-term underperformance, relative to the market and industry group are severe, a negative vote may be cast for the entire slate of directors.

4. Generally, votes are to be cast against blanket requests for limitations of liability and indemnification protection of directors and officers. Generally, such requests allow the protected individual to escape liability even if he or she is found by the courts to have been grossly negligent in the performance of his or her duties as a director and/or officer of the corporation. It is concluded that it is not in the best interest of shareholders to grant such protection on an-across-the-board basis. Exceptions may be made as circumstances and legal requirements dictate.
  - A. Legal requirements and circumstances permitting, positive votes may be cast for management sponsored proposals requesting increased indemnification of directors and officers due to damage caused by violations of the duty of care, so long as the director/officer satisfied a "good faith" standard. Broader protection may be supported, provided there is a reasonable basis for support.
  - B. Legal requirements and circumstances permitting, positive votes may be cast for increased indemnification proposals where a director/officer defense is unsuccessful, unless there is a final legal/court determination that the director/officer acted in bad faith and not for a purpose that he or she could

reasonably believe was in the best interest of the company. Broader protection may be supported, provided there is a reasonable basis for such support.

- C. Legal requirements and circumstances permitting, negative votes may be cast against company proposals that request the elimination or limitation of directors' liability for acts evolving from negligence, or other violations of the duty of care that go beyond reasonable standards, except in markets where local conventions suggest otherwise.
5. Votes may be withheld for the entire slate of directors if a majority of the candidates are also corporate officers. Votes may be cast against the entire slate of directors if a majority of the candidates are also corporate officers or have been corporate officers in the past of the company. Additionally, votes may be withheld when it appears that the existing board has been remiss in the performance of its oversight responsibilities. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
  6. Votes are generally to be cast against the payment of fees to inside directors. Votes are generally to be cast against proposals granting retirement benefits and/or stock options, stock grants to outside directors, except in markets where local conventions suggest otherwise. However, proposals which seek to pay outside directors' fees in stock instead of cash will receive a positive vote. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
  7. Votes may be withheld for directors who may have an inherent conflict by virtue of receiving consulting fees from a corporation such as legal counsel and investment bankers who underwrite the corporation's securities. It is concluded that outside directors should remain independent in order to serve the best interest of all shareholders. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
  8. Generally, votes should be withheld for the entire slate of proposed directors when management is proposing a series of defensive measures, which serve to insulate incumbent management and hinder the ability of mergers or takeovers to proceed. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
  9. Where director candidate(s) are employed by a company having a 20% or greater interest in the subject company, the director candidate(s) will be considered insiders. Should the majority of the director candidates be insiders or have conflicts of interest, votes may be withheld for the entire slate of candidates. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.



10. Generally, shareholder proposals requesting the board of directors to establish a nominating committee for the selection of director candidates are to receive a favorable vote. The System believes that all important review committees such as nominating, audit and compensation should be entirely staffed by independent directors. Proposals and/or actions which seek to have such a structure established may be initiated or supported by STRS. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
11. Proposals which seek to limit the tenure of directors should receive a negative vote. Proposals which require directors to own a minimum amount of company stock in order to qualify as a director or to remain on the board should receive a negative vote. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.

#### **C. CORPORATE GOVERNANCE**

1. Whenever possible, votes will be cast in favor of cumulative voting proposals as required for governmental pension funds under California law. (Section 6900, Government Code)
2. Generally, information, legal requirements and investment analysis permitting, votes may be cast against proposals which would grant preemptive rights to shareholders and in favor of proposals which would eliminate such rights. In some markets, preemptive rights result in a loss of financing flexibility and are likely to deter companies from fulfilling one of their functions, which is to raise capital advantageously. However, in some markets it is believed that the removal of preemptive rights result in a loss of financing flexibility. Thus, the party responsible for executing the vote must exercise his or her best judgement on this matter.

#### **D. EXECUTIVE COMPENSATION**

1. Stock options and incentive compensation plans must have the overriding purpose of motivating corporate personnel. To insure that such plans are cost and performance effective, attention should be paid to corporate performance. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.

“Generally, proposals which only seek to enable corporations to comply with the tax code deductibility rules regarding executive pay are to receive a favorable vote. Exceptions may be made in the instance of mega grants, unclear links between performance, performance hurdles that seem too generous given past history, and no defined peer group by which to judge performance of the subject corporation. Tandem stock options, stock appreciation rights, purchased options may receive a negative vote. Generally, tandem options are a combination of stock options and another type of long-term incentive such as restricted stock or phantom stock. This vehicle can allow for cashless exercise, depending upon the executive choice of exercise or payment. The System is opposed to cashless exercise. Purchased options are usually purchased for a percentage of the grant

value and are payable at the time of grant. The exercise price is set below the fair market value of the underlying stock. Indexed options will be reviewed on a case-by-case basis.”

2. Votes are generally to be cast against executive incentive stock option plans which would result in greater than 10% of the outstanding shares of the Corporation being reserved exclusively for the executive stock option plan, except in markets where local conventions suggest otherwise. This figure includes shares proposed for a new plan or amendment plus shares reserved under all existing plans, plus all shares under option but not yet exercised. Typically, no greater than 1 percent dilution per year for the life of the plan should be experienced by shareholders. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.
3. Votes are generally to be cast against executive incentive stock option plans which would sell shares to executives at a price of less than 85% of market value at the time of grant, unless a lower value may be legally offered.
4. Votes are generally to be cast against executive incentive stock option plans which would grant loans to such executives for the purpose of exercising stock options. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.
5. Votes are generally to be cast against executive incentive stock option plans which would grant loans to such executives to settle tax liabilities associated with the exercising of incentive stock options. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.
6. Votes are generally to be cast against Restricted Stock Option Plans, outright stock grants or other arrangements to such as pyramiding, stock appreciation rights and cashless exercise. Votes are generally to be cast against proposals which would allow the board to replace or reprice underwater options without shareholder approval. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.
7. Executives are defined as the five most highly compensated executive officers of a Company and its subsidiaries, and such other senior-level executive and management employees who are designated to receive executive incentive compensation, apart from that which is given to general employees. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.
8. It is the responsibility of the companies to clearly, understandably, and adequately explain the plans and their effects with examples where necessary in order to fully define intent. However, where time permits, inquiry may be made about corporate proposals which are not clear. If the information available and/or obtained is not considered clear or adequate,

votes cast will be based on the surrounding circumstances and the judgement of the responsible parties.

9. Corporate proposals to reduce stock option share prices for management should be given close scrutiny. If it appears the request arises out of a broad market decline affecting all companies, favorable consideration is possible. If the stock has underperformed the market and it is concluded the causes were management decisions, a negative conclusion would be probable. Such proposals will be considered on a case-by-case basis.
10. Generally, any attempt to create an unusually favorable compensation structure in advance of sale of a company should be opposed; however, such proposals will be considered on a case-by-case basis.

#### **E. EMPLOYEE COMPENSATION**

1. Generally, employee stock purchase plans, savings and investment plans, or thrift plans are to receive a positive vote, so long as exercise or purchase price is not less than 85% of fair market value on the date of grant or purchase, and no loans are made for the purposes of settling payment for shares or any tax liability arising from exercise or purchase of such shares. Shares issued and reserved with respect to such plans shall only be done when necessary and for the specific uses of the plans. However, such proposals will be considered on a case-by-case basis.

Generally, ESOP 's which are funded by the debt of the corporation and/or which represent large percentages of the outstanding shares or cause substantial dilution to ownership and voting power are to be given a careful review. In the absence of any extraordinary or beneficial (to STRS) circumstance, these plans should not be approved. Shareholder proposals which seek to have a vote on all such plans should receive a positive vote.

#### **F. MERGERS, ACQUISITIONS, AND TAKEOVERS**

1. STRS wants all offers evaluated on its behalf, which are presented for any company in which it invests. To the extent that adequate information is available and legal requirements, and investment practices permit, defensive tactics should be opposed. Each proposal should be reviewed on its own merit, as nothing written here should be constructed as a substitute for the judgement of the responsible party. These defensive tactics may be, but are not limited to:
  - A. Golden parachutes.
  - B. Poison-pill preferred.
  - C. Lock-up options.
  - D. Super majority voting provisions, with the exceptions noted above in Section B (2).

- E. Fair price or minimum price provisions.
- F. Unequal voting rights based on length of ownership of stock.
- G. Requiring that shareholders only be allowed to act at meetings rather than by written consent.
- H. Requiring that all offers be approved by the company's management and/or Board of Directors before offers are submitted to shareholders.
- I. Requiring that only the Board be allowed to increase its size, or that a super majority of all outstanding shares is necessary to create a larger Board, and allowing the Board to fill vacancies on the Board in between meetings, without shareholder approval.
- J. Requiring that directors may only be removed for cause, usually on the basis of a supermajority vote, and that directors be allowed to fill vacancies for full terms rather than the remainder of unexpired terms.
- K. Providing for a set of designated "alternate" directors to be appointed to any mid-term vacancy.
- L. Requiring that the power to call a special meeting of the shareholders be vested in the board and/or the Chairman exclusively, or providing that such a meeting can only be called after a demand by a supermajority of stockholders, or increasing the number of shareholders necessary to constitute a quorum at an annual or special meeting.
- M. Adopting supermajority voting provisions for transactions between the target company and an "interested shareholder."
- N. Requiring that the percentage vote requirement be based on all outstanding shares entitled to vote and not on votes actually cast.
- O. Enacting redemption provisions where if any person owns a certain percentage of stock pursuant to a hostile tender offer, which is opposed by the management and/or Board of Directors, the other shareholders have the right to have their shares redeemed by the company at a specified price.
- P. Requiring the Board and/or senior management to consider social, economic and "other factors" when evaluating a bid for the company, rather than basing its decision solely on the price being offered.

- Q. Granting a director who is the Chairman or Chief Executive Officer a second or tie-breaking vote.
  - R. Reincorporating in other states solely for the purpose of seeking protection against tender offers and takeovers.
  - S. Issuance of new common and preferred shares and placing the issues in so called "friendly" hands, sympathetic to management.
  - T. Assuming large amounts of debt which will impair the capital position of the corporation, in order to repurchase the corporation's stock and avoid a tender offer.
2. Each proposal will be evaluated on its merits, but if it is determined that the sole aim of the proposal is to entrench management, and wrest authority and control from shareholders, a vote is to be cast against such proposals. However, this guideline is no substitute for the judgement of the responsible party.
  3. STRS also opposes so-called "Omnibus Resolutions, where management offers one item which is beneficial to shareholders, such as anti-greenmail, and attaches a "rider" or other items such as the ones described above, which are not in the best interests of shareholders. In this situation, a vote will be cast against the entire proposal. A letter (where appropriate) to management may be written by the designated party indicating displeasure with this "lumping" and requesting that the issues be separated.
  4. Generally, votes are to be cast against proposals which adopt or give the Board of Directors discretionary power to adopt measures designed to deter takeover attempts or other attempts to obtain control of the corporation by making such attempts extremely financially unattractive or impossible, unless such action has received the prior approval of the shareholders of that company. However, such actions will be reviewed on a case-by-case basis, and legal requirements and circumstances will dictate the Systems' vote on this matter.
  5. Reincorporation proposals will be examined on a case-by-case basis.

#### **G. CORPORATE FINANCING PROPOSALS**

1. Authorization of increased shares shall generally be limited to that amount which may be necessary for financing within the next twelve months unless the corporation sets forth other compelling reasons. It is deemed advisable to exercise some control over authorized stock and issuance thereof to allow shareholders input on acquisitions which could change the fundamental characteristics of the company held. Support will generally be given for authorization of up to 15% in excess of the current outstanding stock. However, such actions will be reviewed on a case-by-case basis, and legal requirements and circumstances will influence the Systems' vote on this matter.

2. In general, all shareholder proposals on financial matters are to be given due consideration by STRS and/or its advisers. It is incumbent on the companies to respond adequately to these proposals. An inadequate or casual response may affect the responsible party's deliberations and weigh in favor of voting for the shareholder proposal.

(1) Notwithstanding any other provision of the law, every state agency owning common stock shall, when returning proxies to a corporation, vote each proxy that is returned to the corporation. Nothing in this section shall prohibit a state agency owning common stock from abstaining on a corporate or shareholder proposal and notifying the corporation in writing of the state agency's desire to abstain on a corporate or shareholder proposal.

As used in this section "state agency" includes the state, the University of California, and any office, department, bureau, board, commission, agency, or pension or retirement system thereof.

Approved by Board: June 11, 1982

Amended by Investment Committee: June 7, 1985

Amended by Investment Committee: July 19, 1985

Amended by Subcommittee on Financial Proxies: August 5, 1988

Amended by Investment Committee: October 7, 1988

Ratified by Teachers' Retirement Board: October 22, 1988

Amended by Subcommittee on Corporate Governance: March 11, 1992

Approved by Investment Committee: April 1, 1992

Ratified by Teachers' Retirement Board: April 2, 1992

Amended by Subcommittee on Corporate Governance: October 6, 1995

Approved by Investment Committee: October 6, 1995

Ratified by Teachers' Retirement Board: October 6, 1995

Approved by Investment Committee: November 5, 1997

Ratified by Teachers' Retirement Board: November 6, 1997

STATE TEACHERS' RETIREMENT SYSTEM  
STATEMENT OF INVESTMENT RESPONSIBILITY

I. Philosophy

The Teachers' Retirement Board finds that:

It is the fiduciary responsibility of the Board of the State Teachers' Retirement System to discharge its responsibility in the interest of the participants and beneficiaries and for the primary purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the System; the investment policy of the System should reflect and reinforce this purpose.

Public retirement systems operate in a unique and complex social-economic milieu, providing for substantial disclosure of their operations and investment activity and placing them in a position where they should be above that of the private sector in social responsibility activities.

The System's responsibility extends to its participants and beneficiaries and to the general public. In addition to its fiduciary responsibilities to its members, the Board has the social and ethical obligation to require that corporations in which securities are held meet a high standard of conduct in their operations.

The act of investment in the securities of a corporation predominantly reflects a judgment that the ownership will produce a rate of return which will make it an attractive investment. While not outwardly signifying approval of all of a company's policies and products, it is possible however that such investment may be interpreted as an indication of the shareholders approval or support of all of a company's policies and products.

The System is a large investor and as such, is in a position to exert influence on the corporations in which it has invested.

II. Principles

Consistent with these findings, the System establishes the following principles to govern the development of a responsible investment policy:

A. Preservation of Principal and Maximization of Income

The preservation of principal and maximization of income will clearly be the primary and underlying criteria for the selection and retention of securities.

B. Non-Economic Factors

Non-economic factors will supplement profit factors in making investment decisions.

Non-economic factors are defined as those considerations not directly related to the maximization of income and the preservation of principal. The consideration of non-economic factors is for the purpose of ensuring that the Retirement System, either through its action or inaction, does not promote, condone or facilitate social injury.

C. Social Injuries Defined

Social injury will be said to exist when the activities of a corporation serve to undermine basic human rights or dignities. Basic human rights and dignities include, but are not limited to:

1. Equal Employment

Equal employment opportunity, including: fair and equitable recruitment and hiring, equal wages and benefits for equal and comparable worth, fair and equitable promotional and training opportunities, and the right to organize and join representative trade unions and associations if a majority of the employees so elect.

2. Housing

Equal access to safe and decent housing.

3. Basic Services

Equal access to basic services including medical care, transportation, recreation and education.

D. Corporate Practices

Social injury may also be said to exist when the Board, having followed the procedure set forth in Section IV.C.2, perceives that it is the prevailing belief of the members of the Retirement System that the practices of a corporation result in undesirable side effects for others, and that the side effects are grave in nature. Side effects which may be deemed grave in nature shall include, but not be limited to:

1. Environmental

Practices which are known to endanger the environment, subject to current federal, state and local law, including:

- a) Unsafe nuclear waste disposal;
- b) Ineffective or inadequate pollution control; or
- c) Improper use of chemicals and contaminants; or
- d) Any practice which directly or indirectly endangers human health or the environment.

2. Suppression of Human Rights

Practices which result in the suppression of human rights including:



- a) The sale of weapons and technology to governments known to engage in the systematic suppression of human rights; and
- b) The sale or purchase of goods from countries known to employ forced labor.

3. Human Health

Practices which endanger human health including:

- a) Sale and distribution of known contaminated products;
- b) Sale and distribution of therapeutically ineffective or dangerous drugs; and
- c) Purchasing goods from or selling goods to companies known to disregard worker safety.
- d) A company should not be held responsible for the infliction of social injury merely by virtue of its agreements or relationships with other (independent) entities engaged in socially injurious activities.

E. STRS Involvement

The extent of the responsibility of the System to engage in activity for the prevention, reduction, and elimination of social injury should be determined by:

- The number of shares held in the corporation;
- The gravity of the social injury.

In support of the aforementioned principles, the System sets forth the following guidelines for social responsibility in investments.

III. Selecting New Investments

In selecting new investments for the System, the Board adopts the following guidelines for both domestic and international investments.

- A. Investments shall not be selected or rejected based solely on social responsibilities. All investments shall be made subject to the provisions of Chapter 1254, Statutes of 1986, (AB 134).
- B. Social factors shall be taken into consideration to the extent that such factors bear on the financial advisability of the investment; e.g., not investing in a corporation whose poor labor relation practices have directly hampered and continue to hamper the corporation's financial viability.

- C. Generally social criteria, to the extent available, should be considered after all financial criteria have been satisfied. However, the provisions of AB 134 regarding South African investments are an exception to this general guideline. The provisions of AB 134 shall govern the disposition of South African related investments, consistent with the trustees' constitutional fiduciary obligations.

#### IV. Exercise of Shareholder Rights

##### A. Proxy Voting

1. The System has a duty to cast its votes on all proxy issues related to companies in which it holds securities or to abstain with written notification to the company involved on any proxies it returns. In cases of abstention, where an important social responsibility issue is raised, the System should provide an explanation of its action.
2. The System should vote its shares in favor of resolutions which, if implemented, would prevent, reduce, or eliminate social injury as defined above. The System should oppose resolutions which cause or facilitate social injury.
3. If a resolution places a company at a substantial disadvantage with respect to its direct competitors who are equally guilty of inflicting social injury, the System should ascertain whether the company in question has made reasonable effort to induce voluntary industry-wide compliance. If it is determined that this course of action has been pursued, the System should abstain. In the event that a corporation has not initiated such activity, the explanation accompanying abstention should include an exhortation for compliance.
4. The State Teachers' Retirement System, as a major corporate shareholder, will actively vote its proxies to elect corporate board members who share the interests and philosophy of the System.
5. The System should routinely monitor corporate practices for compliance with the Board's criteria, i.e., monitor corporate compliance with the Sullivan principles'.

##### B. Other Shareholder Rights

1. For the purpose of insuring that a company may be made aware of any policies, procedures, or products of which the Board does not approve, and for the purpose of prevention, reduction or elimination of social injury, the Board may initiate action to supplement the responsible voting of proxies including but not limited to: (a) correspondence with the company, (b) meet and confer sessions with management or other stockholders, (c) entering into agreements with

management or other stockholders, such as making provisions for reporting and other monitoring activities, and (d) the initiation, when determined necessary, of shareholder proposals.

C. Procedure

1. Responsibility for the implementation of social responsibility guidelines is delegated to the Board's Investment Committee. Ultimate authority and responsibility rests with the Board.
2. To assist the Board in determining whether social injury exists, the Board should:
  - a. Upon request, permit the presentation of relevant testimony by members of the System and members of the general public during Board meetings;
  - b. Establish contact with appropriate regulatory agencies, such as Equal Employment Opportunity Commission, Environmental Protection Agency, Occupational Safety and Health Agency, Nuclear Regulatory Commission, Securities Exchange Commission, and others which are covered by laws of the United States Government or the State of California;
  - c. Contact qualified persons representing parties affected by the corporate practice in question.

V. Sanctions

- A. When the remedies provided in B (above) indicate that there is little or no possibility of obtaining from a company a commitment to pursue activities designed to correct practices or policies involving grave social injury, the Board should consider either making no new investments or divestment if consistent with sound investment practice. Factors contributing to such a determination include, but are not limited to:
  1. Repeated refusal by management and a majority of stockholders to support shareholder proposals which the Board feels are necessary to insure socially responsible behavior;
  2. Failure of management to comply with Board requests for the disclosure of economic or non-economic information important to making investment decisions, in particular, information pertaining to company practices and policies which might result in social injury.
- B. A company committing social injury should not be subject to consideration for divestment if it is determined that the company is engaged in socially beneficial activity,

where the resulting benefits are held to be greater than the injury. However, it is not the intention of this paragraph to imply a condonation of the social injury, nor does it preclude the exercise of shareholder rights in an effort to reduce such injury.

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